IN THE

Supreme Court of the United States

OCTOBER TERM, 1946

No. 401

THE BROOKLYN NATIONAL CORPORATION,
(In Liquidation),

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION AND BRIEF FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

MEYER KRAUSHAAR,
Attorney for Petitioner.

SUPREME PRINTING CO., INC., 41 MURRAY STREET, N. Y., BARCLAY 7-0349
49

CONTENTS

TABLE OF CASES

IN THE

Supreme Court of the United States

OCTOBER TERM, 1946

No. ———

THE BROOKLYN NATIONAL CORPORATION,
(In Liquidation),

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT OF APPEALS FOR THE SECOND CIRCUIT

To the Honorable Justices of the Supreme Court of the United States:

Petitioner prays that a writ of certiorari issue to review the judgment entered by the Circuit Court of Appeals for the Second Circuit on July 2, 1946, affirming an order of The Tax Court of the United States.

Opinion Below

The opinion of the Circuit Court of Appeals, filed July 2, 1946, is printed in the Record at pages 90-95 and a copy may be found in the Appendix.

Basis of Jurisdiction

Jurisdiction is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925, 43 Stat. 938, 28 U. S. C., Section 347(a).

Questions Presented

Four questions are presented which, petitioner contends, call for determination by this court:

1. Did the Circuit Court of Appeals misconstrue and misapply the rule adopted by this court in *Dobson* v. *Commissioner of Internal Revenue,* 320 U. S. 489, and err by reason thereof in holding that it could not follow its own ruling in *Pembroke Realty & Securities Corp.* v. *Commissioner,* 122 F. (2d) 252, although that ruling is in direct conflict with the judgment of the Tax Court herein and notwithstanding that it was of the opinion that the *Pembroke* case had been correctly decided.

2. Did the Circuit Court of Appeals err in holding that the substantive question presented before it was in effect not a "naked" legal question but one involving tax administration or "a question of proper tax accounting"?

3. Did the Circuit Court of Appeals err in following an erroneous ruling of The Tax Court holding that a personal holding company within the meaning of Sec. 500 of the Internal Revenue Act, Title 26, U. S. C. A. (Sec. 500) which had been legally dissolved and had adopted a *bona fide* plan of liquidation to be completed within three years under I. R. C. Sec. 115(c) was nevertheless liable to be assessed for a personal holding company surtax notwithstanding that it had made distribution to stockholders in accordance with the plan of liquidation?

4. Did the Circuit Court of Appeals err in holding that the petitioner was subject to the personal holding company surtax provisions of the Internal Revenue Code notwithstanding that it was an ordinary business corporation which had, by accident and not design, found itself in a position of having five persons individually owning more than fifty percent of its capital stock?

The first two questions presented are substantially the same as are involved in *Kirschenbaum* v. *Commissioner, No. 279* and *Banner* v. *Commissioner, No. 280,* October Term, 1946, wherein a petition for certiorari is now pending before this court.

Summary Statement

The facts were virtually all stipulated (pp. 12-39*). The only testimony that was taken at the hearing before The Tax Court was on the history of the petitioner and the manner in which five individuals and their families became holders of 51.992% of its capital stock (pp. 47-53).

Petitioner is a corporation organized June 8, 1929, under the laws of the State of Maryland, having had its principal office and place of business in Brooklyn, New York (p. 12, fol. 35). It filed its income and declared value excess-profits tax return and its personal holding company return for the calendar year 1941 with the Collector of Internal Revenue for the First Collection District of New York on March 16, 1942 (p. 12, fols. 35, 36).

Petitioner was organized as a public investment corporation and its entire capital stock was offered for sale to the public in 1929. The extent of ownership and the number of stockholders was not in any way limited in

---

* Pages of the Record.

this offering (pp. 47-49; Pet.'s Exs. 1, 2, pp. 54-73). At no time, from the date of incorporation to the end of the calendar year 1941, did petitioner have less than 300 stockholders (p. 51; Pet.'s Ex. 3, p. 74).

From the date of its incorporation, June 9, 1929, until the date of its dissolution, December 15, 1941, petitioner carried on a general investment business, buying and selling securities on various exchanges, collecting dividends and interest on its securities and making distributions to its stockholders from time to time (p. 50). During this period petitioner also purchased and retired shares of its own capital stock (p. 50, fol. 149). The effect of these purchases was to decrease the total number of shareholders, and to increase the percentage of direct and indirect ownership of the remaining shareholders, so that at December 31, 1940, the direct and indirect ownership of the five principal individual shareholders for the first time exceeded 50%, being 51.353% (p. 52, fol. 154; Pet.'s Ex. 3, p. 74). The discovery of this condition of stock ownership, and the realization that petitioner might technically be considered a personal holding company, resulted in the decision of the directors to dissolve and liquidate in 1941 (pp. 52, 53).

In accordance with the decision of the directors, petitioner's stockholders on November 24, 1941, adopted a plan of dissolution and complete liquidation to be completed within a three-year period. A certificate of dissolution was accordingly filed with the State Tax Commission of Maryland, and dissolution became complete on December 15, 1941 (pp. 13, 14, fols. 38-41).

Pursuant to said plan of complete liquidation, petitioner sold all its assets and paid cash liquidating dividends of $133,980 in each of the calendar years 1941, 1942 and 1943, or a total of $401,940. These distributions disposed of all of petitioner's assets except a small amount

of real estate and cash retained to cover contingent liabilities and liquidation expenses (pp. 14, 15, fols. 41-43).

At December 31, 1941, 51.992% of the petitioner's outstanding capital stock was owned, directly and indirectly, by five individuals (p. 13, fol. 37).

On January 1, 1941, petitioner had a deficit in accumulated earnings and profits in the amount of $72,100.29, and the operations of the taxable year resulted in a net loss of $30,518.06 (p. 15, fol. 43).

Petitioner, in filing its personal holding company return, maintained that it was not liable for any tax under the interpretation given to the statute by this court in *Pembroke Realty & Securities Corporation* v. *Commissioner*, 122 Fed. (2d) 252 (p. 34, fol. 102). Before The Tax Court, it took the same position, and also that it was not a personal holding company within the meaning of the statute (p. 4). The Tax Court decided that petitioner was a personal holding company within the meaning of the statutory definition of that term (p. 77, fol. 229), and that, notwithstanding that the petitioner had legally dissolved and had made distribution to its stockholders of all but a small fraction of its assets, withheld for necessary tax and other contingencies, it was nevertheless held liable for a personal holding company tax. The Tax Court sought to distinguish the facts in this case with those of the *Pembroke* case by pointing out that in the *Pembroke* case the taxpayer "had current earnings during the taxable year, and those earnings rendered it solvent, whereas the operations of this petitioner for the year had resulted in a loss" (p. 79, fol. 235). A further distinction was said by The Tax Court to lie in the fact that in the *Pembroke* case the taxpayer had distributed all of its assets in liquidation so that at the end of the taxable year it retained nothing except a sufficient sum to pay income tax and dissolution expenses, whereas here the taxpayer had "spread its liquidating distributions

over three years" (fol. 236). The Tax Court boldly avowed that if these distinctions were not enough to render the *Pembroke* case inapplicable, it would nevertheless refuse to follow the *Pembroke* case because "its application would be contrary to the law as written by Congress". Judge Arundell, a member of The Tax Court, dissented upon the authority of the *Pembroke* case (fol. 237).

The Circuit Court of Appeals, by a divided court, affirmed the decision of The Tax Court. Both Judge Learned Hand, who wrote for the majority of the court, and Judge Augustus N. Hand, who wrote the dissent, agreed that the ruling theretofore announced in the *Pembroke* case was right, but the majority of the court found itself unable to adhere to this ruling because of this court's decision in the *Dobson* case, *supra*, Judge Learned Hand indicating, however, that if the case had come up through the District Court under the Tucker Act, the court's decision would have been in favor of the taxpayer. Judge Clark, on the other hand, concurred with Judge Learned Hand, holding, as did The Tax Court, that the *Pembroke* case was distinguishable, but if not distinguishable, the Pembroke principle cannot stand "as pleaded to these facts, whatever the decision of The Tax Court, in view of the clear command of the statute".

Reasons for Granting the Petition

1. The Circuit Court of Appeals has misapplied the rule in the *Dobson* case and has virtually abdicated all its statutory power and duty to review the decisions of The Tax Court when called upon in a proper case to do so.

2. The decision of the Circuit Court of Appeals is in direct conflict with the decision in The Tax Court, thereby completely unsettling the law.

3. The decision of The Tax Court is not only in conflict with the rule laid down by the Second Circuit not only in the *Pembroke* case, but likewise in conflict with the Sixth Circuit in *Knight Newspapers* v. *Commissioner*, 143 F. (2d) 1007, which cited and followed the *Pembroke* decision (see p. 1010), and with *Piper* v. *U. S.*, D. C. Minnesota (1943), 50 Fed. Supp. 363.

4. Notwithstanding the unanimity of opinion of the Eighth, First, Fourth and Second Circuits in the following cases: *Foley Securities Corp.* v. *Commissioner*, 106 F. (2d) (8th Cir.) 731; *Noteman* v. *Welsh*, 108 F. (2d) (1st Cir.) 206; *Fides* v. *Commissioner*, 137 Fed. (2d) (4th Cir.) 731; *O'Sullivan* v. *Commissioner*, 120 Fed. (2d) (2nd Cir.) 845, the petitioner was not a personal holding company within the meaning of Sec. 500, *et seq.* I. R. C.

WHEREFORE, it is respectfully submitted that this petition for a writ of certiorari to review the judgment of the Circuit Court of Appeals for the Second Circuit should be granted.

MEYER KRAUSHAAR,
Attorney for Petitioner,
42 Broadway,
New York 4, N. Y.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1946

No. ————

THE BROOKLYN NATIONAL CORPORATION,
(In Liquidation),
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

Opinion Below

The opinion below has been referred to in the petition for writ of certiorari under this same caption and a copy may be found in the appendix.

Jurisdiction

The statement as to jurisdiction has been set forth in the petition.

Statement of the Case

The facts have been stated in the Summary Statement contained in the petition.

Specifications of Error

1. The Circuit Court of Appeals erred in holding that under the Dobson rule it was precluded from reviewing the determination of The Tax Court.

2. The Circuit Court of Appeals erred in holding in effect that the rule of the *Pembroke* case, 122 F. (2d) 252, followed in *Piper* v. *United States*, 50 F. Supp. 363, and quoted with approval in *Knight Newspapers* v. *Commissioner of Internal Revenue*, 143 F. (2d) 1007 (6th Cir.), constitute a matter of tax administration or tax accounting, and erred in refusing to hold that the same constitutes a proper and reasonable interpretation of the statute, the facts herein being substantially identical.

3. The Circuit Court of Appeals erred in holding that petitioner was a personal holding company and subject to a personal holding company surtax.

ARGUMENT

I.

The Circuit Court of Appeals erred in holding that under the Dobson rule it was precluded from reviewing the determination of The Tax Court.

The Circuit Court of Appeals has so interpreted the Dobson rule as to render it absurd. Judge L. Hand, in his opinion here, has reiterated his views expressed in *Kirschenbaum* v. *Commissioner*, 155 F. (2d) 23, from the decision in which an application for certiorari is now pending in this court, wherein he points out, at page 24:

> "Perhaps we should stop with that; *but tax cases do not all come up through the Tax Court;*

> taxpayers sometimes pay their assessments and sue in the District Court. * * * That there should be one answer when the taxpayer pays his assessment and sues to recover it, and another when he resists collection, may appear inconsistent; but, if consistency is eventually to prevail, it has not done so yet."

This court, in the *Dobson* case, 320 U. S. 489, at page 495 of its opinion, recognized that under the Tucker Act the District Court is empowered to take jurisdiction for the recovery of taxes alleged to have been "erroneously or illegally assessed or collected. 28 U. S. C. sec. 41(20), 28 U. S. C. A. sec. 41(20)." Thus, had petitioner paid the taxes and sued for its recovery under the Tucker Act, it would undoubtedly have recovered; and yet, by seeking to review the assessment in The Tax Court, the petitioner has been mulcted for a tax which everyone concedes is contrary to the spirit of the law and intent of Congress, but which is held to be in accordance with the strict letter. "Such a result", observes Judge Augustus N. Hand in his dissenting opinion, "contravenes the purposes of the Congressional legislation while following a slavishly literal reading of the statute."

One of the Congressional purposes in establishing the jurisdiction of The Tax Court, or The Board of Tax Appeals, as it was then called, was to enable review of an assessment before the taxpayer should be compelled to part with the tax and be deprived of the use of the capital while the assessment is under review. Thus the result of the application of the Dobson rule means that a rich taxpayer who can afford to pay the tax may do so, sue for its recovery in the District Court and recover, while a taxpayer who cannot afford to pay is penalized. All he gets is a short postponement of the time in which to pay the tax, which he must do with interest, whereas

if he pays the tax, he may recover the same with interest from the government in an action under the Tucker Act. Certainly such a result could not have been contemplated by Congress and the same would be, we submit, repugnant to the clear language of §1141(c)(1) of the Internal Revenue Code, which empowers the Circuit Court of Appeals for the District of Columbia, as well as this court, to review the decisions of The Tax Court and

> "(c)(1) Upon such review, such courts shall have power to affirm or, if the decision of the Board is not in accordance with law, to modify or to reverse the decision of the Board, with or without remanding the case for a rehearing, as justice may require."

We respectfully submit that the Dobson rule enunciated by this court did not intend to have the effect of divesting the Circuit Court of Appeals or the Court of Appeals of the District Court of Columbia of jurisdiction to review on questions of law the decisions of The Tax Court. All that this court intended by the Dobson rule was to render The Tax Court's determinations on administrative matters final and not to permit invasion of this province by the regular courts. What this court merely held was to deny to the courts the right "of treating as a rule of law what * * * is only a question of proper tax accounting". (Opinion of Mr. Justice Jackson in the *Dobson* case, at pages 506, 507.)

Here, we have no administrative question or a question involving proper tax accounting, but a simple case of disputed statuory construction, which is peculiarly the province of the regular courts rather than of a tribunal whose powers are mixed, viz. administrative as well as judicial. We cannot believe it possible that a tax case such as this can be wrecked upon the rocks of a mistaken choice of procedure.

II.

The Circuit Court of Appeals erred in holding in effect that the rule of the *Pembroke* case, 122 F. (2d) 252, followed in *Piper* v. *United States*, 50 F. Supp. 363, and quoted with approval in *Knight Newspapers* v. *Commissioner of Internal Revenue*, 143 F. (2d) 1007 (6th Cir.), constitutes a matter of tax administration or tax accounting, and erred in refusing to hold that the same constitutes a proper and reasonable interpretation of the statute, the facts herein being substantially identical.

We are here confronted with a principle that the courts will often declare that a thing which is within the letter of the statute is not governed by the statute because not within its spirit or the intention of its makers. *Holy Trinity Church* v. *United States*, 143 U. S. 457, 472; *Lau Ow Bew* v. *United States*, 144 U. S. 47, 59; *Gregory* v. *Helvering*, 69 F. (2d) 809, aff'd 293 U. S. 465; *Fleischman Const. Co.* v. *United States*, 270 U. S. 349. This is substantially the theory upon which the decisions in the *Pembroke* case and the *Piper* case proceed.

The chief purpose of the personal holding company statute is to compel corporations within its scope to distribute their current earnings to stockholders. (See Congressional Committee Reports on 1934 Revenue Act, CB 1939-1, Part 2, pp. 554, 586.) In accordance with this primary purpose, I. R. C. Sec. 500 imposes the surtax only upon "undistributed subchapter A net income", and in defining "undistributed subchapter A net income" I. R. C. Sec. 504(a) allows a credit for dividends paid, including liquidating dividends. However, in determining the amount of credit for liquidating dividends, I. R. C. Sec. 27(g) limits such credit to "the part of such dis-

tribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913".

Under a strict and literal interpretation of the above provisions of the statute, a corporation which has accumulated earnings would be exempted from the surtax by making distributions in liquidation, while a corporation which has an accumulated deficit would not. The corporation with a deficit would have done exactly the same thing as the corporation with a surplus, *i. e.*, distributed to stockholders not merely its current earnings but all its assets in complete liquidation. Such an interpretation is manifestly absurd, since it is exactly contrary to the purpose of the statute. Yet, this is precisely the construction placed upon the statute by The Tax Court, in direct conflict with the views expressed by the Circuit Court of Appeals and on the principle that this is the way the statute was written, regardless of Congressional intention.

In the *Piper* case, 50 F. Supp. 363, at page 365, Judge Nordbye expressed the matter cogently as follows:

> "This is particularly true when we consider the purpose of Section 351 of the 1934 Revenue Act. The congressional history of this legislation unmistakably indicates that it was devised to drive the current income of the personal holding corporation to its shareholders. In the instant situation, this was done. That which Congress sought to achieve by the legislation was attained. In effect, however, the Government is now seeking to penalize the corporation for doing that which the statute intended to produce. The fact that the corporation liquidated at the time that the earnings were turned over to the shareholder is immaterial. No cogent reason is suggested in support of any theory which denies the right of the deduction made herein.

> If the Government's position is upheld, we have the anomalous situation of a tax being assessed on the hypothesis that the current earnings never reached the shareholder, when the contrary is true."

Judge Clark's view that corporate earnings would be rendered non-taxable by the Pembroke decision or that the taxpayer had so contended is untenable since here there were no earnings whatever for income tax purposes. The tax here is not based upon income, but is a penalty for failing to distribute so-called earnings which in fact were not earnings at all in the true sense inasmuch as the capital had been impaired. They could not legally be distributed without rendering the directors liable for a violation of state statutes prohibiting the payment of dividends in these circumstances. And the statutory purpose was not primarily to tax income but to prevent the hoarding thereof to evade taxes to the distributees. No such purpose is here apparent and the rule adopted by The Tax Court is unjust and unfair to the taxpayer.

III.

The Circuit Court of Appeals erred in holding that petitioner was a personal holding company and subject to a personal holding company surtax.

Here, again, we come to a situation where "the letter killeth, but the spirit giveth life". The purpose of the personal holding company statute was to prevent the use of "an incorporated pocketbook" to evade taxation. No such intent is, concededly, here present. The taxpayer came accidently within the scope of the "stock requirement of the law" solely by a gradual contraction of the number of outstanding shares. Prior to 1940 the num-

ber of outstanding shares was such that no five individuals owned more than 50% of the stock. During 1940 and thereafter the ownership of the 5 principal shareholders, after taking into account all cases of indirect ownership, was slightly in excess of 50%. Clearly, Congress did not intend that such a corporation should be penalized. Yet the Circuit Courts have uniformly held likewise in *Foley Securities Corp.* v. *Commissioner* 106 F. (2d) 8th Cir. 731; *Noteman* v. *Welsh,* 108 F. (2d) 1st Cir. 206; *Fides* v. *Commissioner,* 137 F. (2d) 4th Cir. 731; *O'Sullivan* v. *Commissioner,* 120 F. (2d) 2nd Cir. 845. The rationale of the foregoing decisions is that the courts will not legislate where the statute is clear in its meaning. Unless "literally interpreted", it will lead to "absurd results or arbitrary discrimination". (Darby, J., C. J., in the *Fides* case, *supra,* 137 F. (2d) 731.) Here, we believe the result of a literal interpretation is both absurd and discriminatory.

CONCLUSION

It is therefore urged that the petition for a writ of certiorari should be granted.

Respectfully submitted,

MEYER KRAUSHAAR,
Attorney for Petitioner,
42 Broadway,
New York 4, N. Y.

APPENDIX

UNITED STATES CIRCUIT COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 232—October Term, 1945.

(Argued June 4, 1946 Decided July 2, 1946.)

Docket No. 20137

BROOKLYN NATIONAL CORPORATION,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Before:

L. HAND, AUGUSTUS N. HAND and CLARK,

Circuit Judges.

On petition by the taxpayer to review an order of the Tax Court, assessing a deficiency in the petitioner's "personal holding company surtax" for the year 1941.

JOHN SCOTT STELL, *for the petitioner.*

MARYHELEN WIGLE, *for the respondent.*

L. HAND, *Circuit Judge*:

This is an appeal from the assessment of a deficiency against the taxpayer in its "personal holding company surtax" for the year 1941. Two issues are raised: first, whether the taxpayer was a "personal holding company"; and, second, whether, if so, it was exempt from any surtax, because it distributed all its earnings of that year. The facts were stipulated, and were in substance as follows. The taxpayer is a Maryland corporation and did business in Brooklyn as a public investment company: its capital stock being offered for sale to the public generally from 1929 forward. At no time until the end of the calendar year 1941, did it have less than three hundred shareholders; but during the year 1940 it purchased and retired so many of its shares that on December 31, 1940, five shareholders collectively owned a little more than fifty per cent; and this continued throughout the year 1941. Realizing that this might expose the company to a "personal holding company surtax," it was decided to dissolve and liquidate; and on the 24th of November, 1941, the shareholders passed a resolution to liquidate the company within a period of three years. A proper certificate was filed with the State Tax Commissioner of Maryland, and the dissolution was completed on December 15th of that year. The total assets realized upon liquidation were $401,940, and this sum was paid out in three equal dividends of $133,980 in each of the years 1941, 1942 and 1943. During the year 1941 it suffered "long term capital losses" of $43,083.93, and had "short term capital gains" of $6,198.07; it received dividends of $20,096.16; and other income of $1,564.46. Its total deductions were $9,639.55. Therefore, omitting its net capital losses, its net income was $12,021.07. In computing its income tax it deducted $2000—the only capital loss allowed by §505(d)—and charged itself with $10,021.07. However it claimed the right to offset this on the ground

that it had distributed the whole of its earnings and was entitled to the "dividends paid credit" allowed by §504(a). This credit the Commissioner disallowed, and assessed against it a "personal holding corporation surtax," based upon an income of $10,021.07. The Tax Court—*en banc*, one judge dissenting—affirmed this assessment on two grounds: first, that the company was a "personal holding company"; and second, that our decision on which the company relied—*Pembroke Realty and Securities Corp.* v. *Commissioner*, 122 Fed. (2) 252—did not cover the case; and if it did, "with all due respect to the Circuit Court of Appeals of the Second Circuit, to which an appeal in this case will lie, we decline to apply the *Pembroke* case here, because we think its application would be contrary to the law as written by Congress."

That the company was a "personal holding company" within the meaning of §501(a)(2) admits of no doubt. The only argument to the contrary is that it should not properly be deemed an "incorporated pocket-book," because its shares had always been bought and sold freely on the market, because it was never closely held, and because it was only by chance that at the end five shareholders had come to own more than half the shares. This we cannot accept; so far as we can see, there is no reason to suppose that, had Congress had such a company in mind, it would have wished to except it. The majority of shareholders would be in control, it would be to their interest to avoid high personal surtaxes, and that interest might well be enough to impel them to spread over a number of years the distribution of its earnings: exactly what the statute was aimed to prevent. True, there is often no surer way to misconceive the meaning of a statute or any other writing than to construe it verbally; indeed, interpretation is the art of proliferating a purpose which is meant to cover many occasions so that it shall be best realized upon the occasion in question. However, although

there are no certain guides, the colloquial meaning of the words is itself one of the best tests of purpose, and situations of which *Markham* v. *Cabell*, 326 U. S. 404, is the last example are the exception. We have no doubt that as to the first point, this is not a situation in which it would be proper not to follow the literal meaning of the words.

The second question raises the perplexing question of the limitations upon our power to review decisions of the Tax Court. In August 1941 we reversed the Board of Tax Appeals, and held that, when a "personal holding company" was in liquidation, the distribution of any earnings made in that year entitled it *pro tanto* to a "dividends paid credit" under §504(a), in spite of §115(c) which declared that such distributions should not be treated as dividends, but must be brought into hotchpot in an equation of loss or gain. *Pembroke Realty and Securities Corp.* v. *Commissioner, supra* (122 Fed. (2) 252). In the case at bar the Tax Court has held that this was wrong and has flatly refused to follow it, although it suggested a possible distinction: *i.e.*, that here there were no earnings to distribute at all in the year 1941, if one counter "net capital losses" for that year; while in *Pembroke Realty and Securities Corp.* v. *Commissioner, supra,* there were earnings, unless one counted the capital impairment as a loss. We cannot agree that this is a tenable difference, and the Tax Court itself obviously put it forward without conviction. Since §505(d) is one of the specific directions by which to compute the "personal holding company surtax," and since it particularly provides that "losses from sales * * * of capital assets shall be allowed only to the extent of $2000," it seems plain that no capital losses beyond $2000 should be allowed in computing the "Subchapter A Net Income" of §505, from which the deductions (among them the "dividends paid credit") allowed by §504 are to be subtracted,

in order to ascertain the "Undistributed Subchapter A Net Income." There is nothing extraordinary in that; it is true that losses and gains are assumed to occur in the year in which they are "realized," but that is merely a convention, which Congress was free to use or not at its pleasure. Dividends are received as much in years when old losses are "realized," as dividends are received although capital has been previously impaired.

So much taken for granted, the question arises whether we should yield to the Tax Court's ruling that we were wrong, and that it would not follow us. What it said, might of course change our opinion on the point, in which event there would no longer be any conflict; but in the case at bar it chances that this has not happened; and, if the case were an appeal from a district court, we should have no alternative but to reverse. But the Supreme Court has repeatedly admonished us (in so many decisions that it would be idle to repeat them), that our power to review a ruling of the Tax Court is very much more limited than in the case of a district court. As we understand it, before we may substitute our own interpretation of a provision of the Revenue Act, not only must a naked question of law detach itself from the nexus of law and fact in the record as a whole; but we must conclude that the Tax Court has been indubitably wrong in its decision of the question which emerges: reasonable differences in legal opinion we are to resolve in its favor. We have recently discussed the matter in *Kirschenbaum* v. *Commissioner*, 155 Fed. (2) 23, and have now nothing to add to what we said. It seems to us that the right answer to whether §115(c) is controlling here is not so certain that we should be justified in following our own beliefs; and therefore, although personally we are of the same mind as before, we think that we should yield to the insistence of the Tax Court, which within these limits is really the court of last appeal. One

question remains. It may be asked why the same reasoning did not apply, when in *Pembroke Realty and Securities Corp.* v. *Commissioner, supra* (122 Fed. (2) 252), we reversed the holding of the Board of Tax Appeals. It did; but in August, 1941, the Supreme Court had not yet made clear, as it now has, how straitly our jurisdiction is confined. Our decision was then wrong, not indeed because as an original question it was, but because, by assuming jurisdiction to consider the question at all, we invaded the prerogative of the Tax Court and disregarded the finality of its orders. That finality depends, as we understand, upon the added competency which inevitably follows from concentration in a special field. Why, if that be so, we—or indeed even the Supreme Court itself—should be competent to fix the measure of the Tax Court's competence, and why we should ever declare that it is wrong, is indeed an interesting inquiry, which happily it is not necessary for us to pursue.

Order affirmed.

CLARK, *Circuit Judge* (concurring):

I agree with the result and with all of the opinion except for the two conjoined statements that *Pembroke Realty and Securities Corp.* v. *Commissioner, supra,* is indistinguishable, and that personally we are of the same mind as when it was announced. Though I did not participate in that case, I should suppose it distinguishable. There at least the statutory purpose had been accomplished by a distribution of earnings which went to swell the taxable income of the distributees; here, on the taxpayer's contention, the corporate earnings would be strictly nontaxable. But if I am wrong and the distinction is not sufficient, I do not see, for my part, how the *Pembroke* principle could have stood as applied to these facts, whatever the decision of the Tax Court, in view of the clear command of the statute.

AUGUSTUS N. HAND, *Circuit Judge* (dissenting):

Under the prevailing opinion this court would seem to be given a purely technical power of review only in order to satisfy the conventional aspiration for such a procedural step rather than for the purpose of affording relief to aggrieved litigants. I am not satisfied that the dice are so heavily loaded against any decision which differs from the Tax Court that our jurisdiction is rendered almost futile, nor do I believe that the opinions of the Supreme Court call for complete abdication on our part.

The determination of the Tax Court while disapproved of by the prevailing opinion is nevertheless affirmed for lack of power to give any relief. It purports to tax an accumulation of income—though there in fact was none—but, on the contrary, a deficit in capital during the taxable year. Such a result contravenes the purposes of the Congressional legislation while following a slavishly literal reading of the statute. In my opinion the *Dobson* decision does not preclude us from determining such a general question of law as whether the statute covers distributions in liquidation where no earnings or profits exist. Such lack of power would render appeals to this court meaningless and, if our view of the interpretation of the statute is correct, tragic for the taxpayer in the present case.

I think that the order of the Tax Court should be reversed.

INDEX

CITATIONS

713408—46——1

In the Supreme Court of the United States

OCTOBER TERM, 1946

No. 401

THE BROOKLYN NATIONAL CORPORATION (IN LIQUIDATION), PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 75–79) is reported at 5 T. C. 892. The opinion of the Circuit Court of Appeals (R. 89–94) is not yet reported.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered July 2, 1946. (R. 94.) The petition for writ of certiorari was filed on August 14, 1946. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the Tax Court erred in holding that the petitioner was subject, under Section 500 of the Internal Revenue Code, to the surtax on personal holding companies for the taxable year 1941, despite the facts (1) that the petitioner was not originally formed as such a company, and (2) that during the taxable year it was dissolved and paid liquidating dividends in excess of its 1941 subchapter A net income.

STATUTES INVOLVED

These will be found in the Appendix, *infra*.

STATEMENT

The facts, summarized from the Tax Court opinion (R. 75–77), are as follows:

The petitioner is a Maryland corporation organized in 1929. It filed a personal holding company return for the calendar year 1941. (R. 75–76.)

More than 50 percent in value of petitioner's outstanding stock was owned directly or indirectly by not more than five individuals during 1941. More than 80 percent of its gross income for the calendar year 1941 consisted of personal holding company income as defined in Section 502 of the Internal Revenue Code. (R. 76.)

The petitioner had no accumulated earnings or profits on January 1, 1941, but had a deficit at that time in the amount of $72,100.29. Its operations during the taxable year resulted in a

net loss of $30,518.06. One of the items entering into this loss was a net long-term capital loss of $43,083.93. Its subchapter A net income for 1941, as defined by Section 505 (a) of the Internal Revenue Code, was $4,367.80. (R. 76.)

Petitioner was engaged in the purchase, holding, and sale of securities, which business had not proved successful. Its stock was offered for sale to the public when it was organized in 1929. There were in the beginning about 500 stockholders, but this number was reduced by the petitioner's buying up of its stock until there were only 333 stockholders at the end of 1941. Petitioner's directors discovered in 1940 that more than 50 percent of the value of the outstanding stock was owned directly or indirectly by not more than five individuals. They realized that, as long as the capital was impaired, dividends could not be paid under the law, and that if dividends were not paid, the corporation might be taxed as a personal holding company. The stockholders adopted a resolution in November, 1941, dissolving the corporation and authorizing its liquidation, including the distribution of its assets, within three years from the date of the resolution. Articles of dissolution filed with the State Tax Commission of Maryland were approved on December 15, 1941. (R. 76.)

Petitioner paid liquidating dividends to its stockholders in the amount of $133,980 in each of

the calendar years 1941, 1942, and 1943. The assets remaining at the end of 1943 consisted of cash in the amount of $19,818.60, real estate of the value of $5,965.38, and prepaid insurance of $66.57. The sole asset of the corporation held at the end of 1944 was cash in the amount of $25,685.64. (R. 77.)

The Tax Court held, one judge dissenting, that the Commissioner had correctly asserted a personal holding company surtax against petitioner for the year 1941. (R. 79.) The court below affirmed, Judge A. N. Hand, dissenting. (R. 89–94.)

ARGUMENT

Section 500 of the Internal Revenue Code (*infra*, p. 10) imposes a surtax upon "undistributed subchapter A net income of every personal holding company." Two questions are here presented: first, whether the taxpayer was a "personal holding company"; and second, even if it were a personal holding company, whether it had any "undistributed subchapter A net income."

1. Section 501 (a) (2), in defining a "personal holding company", specifies that at any time during the last half of the taxable year more than 50 per cent in value of its stock must be owned directly or indirectly by "not more than five individuals". It is true that the taxpayer herein, when originally organized in 1929, was not a personal holding company within the meaning of the

statute; but, as a result of the corporation's repurchase of a number of shares of its own stock, more than 50 per cent of its outstanding stock was owned by not more than five individuals during the taxable year 1941. Accordingly, there is full compliance with the statutory requirement. However, the taxpayer seeks relief from the statute on the ground that it was not organized or utilized for the purpose against which the statute was aimed. But the statute is satisfied where its terms are met; it does not require any investigation into the illusive subjective realm of motivation. The Tax Court so held, and none of the judges in the court below disagreed. The decision on this issue is plainly correct and certainly does not call for further review.

2. The surtax imposed upon a personal holding company by Section 500 is measured by its "undistributed subchapter A net income". In this case, it is undisputed that the taxpayer corporation had "subchapter A net income" in the amount of $4,367.80 for the taxable year 1941. (R. 76, 77). "Subchapter A net income" is purely a statutory concept, and is computed in accordance with the directions set forth in Section 505, *infra,* p. 12. A corporation may have "subchapter A net income" as a result of limitations upon deductions in Section 505, even though it may not have any "net income". Such was the

case here for the year 1941; the Tax Court so held, and none of the judges in the court below disagreed.

The crux of this case is whether the subchapter A net income for 1941 was "undistributed" during that year. The taxpayer contends in effect that against its subchapter A net income there must be charged its 1941 distribution in liquidation (there were distributions in liquidation in the amount of $133,980 in each of the calendar years 1941, 1942 and 1943), with the result that it had no "undistributed" subchapter A net income subject to tax. As the Tax Court pointed out, however, resort must be had to the statute in determining how much is "undistributed", and, under the statute, the "dividends paid" credit must be limited by Section 115 which defines "dividend". But the taxpayer's liquidating dividend failed to qualify as a dividend under Section 115 and was simply a distribution in liquidation which did not bring about any distribution of "earnings or profits" since the corporation had none to distribute.

The difficulty that may perhaps arise at first blush in this connection is due to the fact that the case involves technical statutory concepts such as "net income", "subchapter A net income", "dividend", and "earnings and profits". The Tax Court, however, scrupulously applied these statutory concepts in accordance with explicit statutory directions. The affirmance of its decision

was therefore correct, although it may be doubted whether the scope of review in the court below is as narrow as was indicated in Judge Learned Hand's opinion. Cf. *Trust of Bingham* v. *United States,* 325 U. S. 365.

In announcing that he felt bound to affirm the Tax Court's decision Judge Learned Hand indicated a preference for the earlier decision of the court below in *Pembroke Realty & S. Corp.* v. *Commissioner,* 122 F. 2d 252. But in the *Pembroke* case, the corporation did have current earnings which the distribution in question necessarily included since none of the assets were retained by the corporation beyond the tax year. Thus the ultimate purpose of Congress in enacting the personal holding company tax law was not defeated by permitting the Pembroke corporation to escape the surtax, for to the extent that the distribution was composed of earnings it was taxable in the hands of the distributees; that point is made in the *Pembroke* opinion (p. 254), and it was emphasized as a pivotal distinction in Judge Clark's concurring opinion herein. (R. 93.) The taxable income of the distributees was not increased in the least by the distribution in the case at bar—yet the corporation did indubitably have subchapter A net income.

In the circumstances, since the decision of the Tax Court herein was correct, and since the only basis for challenging that decision on this issue

was the *Pembroke* case which is distinguishable, further review of this case does not appear to be called for.

CONCLUSION

The petition for writ of certiorari should be denied.

Respectfully submitted.

J. HOWARD MCGRATH,
Solicitor General.
DOUGLAS W. MCGREGOR,
Assistant Attorney General.
SEWALL KEY,
ROBERT N. ANDERSON,
MARYHELEN WIGLE,
Special Assistants to the Attorney General.

SEPTEMBER 1946.

APPENDIX

Internal Revenue Code:

SEC. 27. CORPORATION DIVIDENDS PAID CREDIT.

(a) *Definition in general.*—As used in this chapter with respect to any taxable year the term "dividends paid credit" means the sum of:

(1) The basic surtax credit for such year, computed as provided in subsection (b);

* * * * *

(b) *Basic surtax credit.*—As used in this chapter the term "basic surtax credit" means the sum of:

(1) The dividends paid during the taxable year, increased by the consent dividends credit provided in section 28, and reduced by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations;

* * * * *

(g) *Distributions in liquidation.*—In the case of amounts distributed in liquidation the part of such distribution which is properly chargeable to the earnings or profits accumulated after February 28, 1913, shall, for the purposes of computing the basic surtax credit under this section, be treated as a taxable dividend paid.

* * * * *

(26 U. S. C. 1940 ed., Sec. 27.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of dividend.*—The term

"dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

* * * * *

(26 U. S. C. 1940 ed., Sec. 115.)

SEC. 500 [as amended by Section 110 (a) of the Revenue Act of 1941, c. 412, 55 Stat. 687]. SURTAX ON PERSONAL HOLDING COMPANIES.—There shall be levied, collected, and paid, for each taxable year beginning after December 31, 1938, upon the undistributed subchapter A net income of every personal holding company (in addition to the taxes imposed by chapter 1) a surtax equal to the sum of the following:

(1) 71½ per centum of the amount thereof not in excess of $2,000; plus

(2) 82½ per centum of the amount thereof in excess of $2,000.

(26 U. S. C. 1940 ed., Sec. 500.)

SEC. 501. DEFINITION OF PERSONAL HOLDING COMPANY.

(a) *General rule.*—For the purposes of this subchapter and chapter 1, the term "personal holding company" means any corporation if—

(1) *Gross income requirement.*—At least 80 per centum of its gross income for the

taxable year is personal holding company income as defined in section 502; but if the corporation is a personal holding company with respect to any taxable year beginning after December 31, 1936, then, for each subsequent taxable year, the minimum percentage shall be 70 per centum in lieu of 80 per centum, until a taxable year during the whole of the last half of which the stock ownership required by paragraph (2) does not exist, or until the expiration of three consecutive taxable years in each of which less than 70 per centum of the gross income is personal holding company income; and

(2) *Stock ownership requirement.*—At any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

* * * * *

(26 U. S. C. 1940 ed., Sec. 501.)

SEC. 504 [as amended by the Act of March 17, 1941, c. 21, 55 Stat. 44]. UNDISTRIBUTED SUBCHAPTER A NET INCOME.—For the purposes of this subchapter the term "undistributed subchapter A net income" means the subchapter A net income (as defined in section 505) minus—

(a) The amount of the dividends paid credit provided in section 27 (a) without the benefit of paragraphs (3) and (4) thereof (computed without its reduction, under section 27 (b) (1), by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations); but, in the computation of the

dividends paid credit for the purposes of this subchapter, the amount allowed under subsection (c) of this section or of section 405 of the Revenue Act of 1938 in the computation of the tax under this subchapter or under Title IA of the Revenue Act of 1938 for any preceding taxable year beginning after December 31, 1937, shall be considered as a dividend paid in such preceding taxable year and not in the year of distribution;

* * * * *

(26 U. S. C. 1940 ed., Sec. 504.)

SEC. 505 [as amended by Section 211 (i) and Section 212 (d) of the Revenue Act of 1939, c. 247, 53 Stat. 862].

SUBCHAPTER A NET INCOME.—For the purposes of this subchapter the term "Subchapter A Net Income" means the net income with the following adjustments:

(a) *Additional deductions.*—There shall be allowed as deductions—

(1) Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year to the extent not allowed as a deduction under section 23; but not including the tax imposed by section 102, section 500, or a section of a prior income-tax law corresponding to either of such sections.

* * * * *

(c) *Net loss carry-over disallowed.*—The deduction for net operating losses provided in section 23 (s) shall not be allowed.

(d) *Capital losses.*—The net income shall be computed without regard to section 117 (d) and (e), and losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains

from such sales or exchanges. (26 U. S. C. 1940 ed., Sec. 505.)

SEC. 507. MEANING OF TERMS USED.

The terms used in this subchapter shall have the same meaning as when used in chapter 1.

U. S. GOVERNMENT PRINTING OFFICE: 1946